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IN THE

Supreme Court of the United States

OCTOBER TERM, 1955

No.

CITY CHEVROLET COMPANY, *Petitioner*

vs.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

To the Honorable, the Chief Justice and Associate Justices of the Supreme Court of the United States:

The Petitioner, City Chevrolet Company, respectfully prays that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Fourth Circuit entered in the above entitled cause on January 11th, 1956.

OPINIONS BELOW

The opinion of the Court of Appeals (Appendix "A", infra, pp. 20a-21a) has not yet been officially reported. The Memorandum Findings of Fact and Opinion of the Tax Court (Appendix "A", infra, pp. 1a-19a) is not officially reported.

JURISDICTION

This case involves deficiency in income tax and originated in the Tax Court by the filing of a petition for review pursuant to Section 272(a)(1) of the Internal Revenue Code (26 USC 272). The judgment of the Court of Appeals was entered on January 11th, 1956, (App. A, infra). The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTIONS PRESENTED

The Court of Appeals for the Fourth Circuit affirmed, per curiam, a decision of the Tax Court denying the petitioner a full deduction in 1946 for bonuses paid its officers for the year 1946 in accordance with bonus contracts initiated years prior thereto when all voting stock of the corporation was owned by "strangers".

The questions are:

1. Whether the decisions of the Courts below were contrary to law in determining that a change in the stock ownership of a corporation vitiates its compensation contracts with its employees, for federal tax purposes.

2. Whether the decisions of the Courts below were contrary to law in disregarding the testimony of qualified and experienced witnesses when the respondent offered no witnesses or evidence to justify disallowance of the portion of the compensation which he asserted to be unreasonable.

STATUTE AND REGULATIONS INVOLVED

The relevant provisions of the Internal Revenue Code and of the Regulations promulgated thereunder are set forth in Appendix B, infra.

STATEMENT

City Chevrolet Company, the petitioner, is a North Carolina Corporation with its principal place of business in Charlotte, North Carolina. Since the date of its incorporation in January, 1935, it has sold and repaired new and used motor vehicles, supplies, parts and accessories and has acquired and operated facilities for such purposes.[1]

General Motors Holding Corporation[2] invested its money ($27,000.00) in the Class A voting stock and P. Abernethy invested his ($3,000.00) in the Class B non-voting stock of petitioner.

Petitioner hired Abernethy as its President and Operator and agreed to pay him a salary and bonus. General Motors also gave him an option to buy its Class A stock out of dividends and bonus. Under the plan Abernethy bought A stock and had to convert it to B stock. Not until all of the A stock had been converted and eliminated did the B stock acquire voting privileges. Abernethy bought out General Motors in March 1941. (Appendix A, infra, pp. 4a-6a)

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[1] References are either to selected portions of the Tax Court record printed in the Appendix in petitioner's brief in the Court below, or to those undisputed findings of fact contained in the Tax Court's Memorandum Findings of Facts and Opinion contained in Appendix A hereof.

[2] General Motors Holding Corporation was the dealership investment subsidiary of General Motors Corporation, formed to enable men of ability and promise to assume management of dealerships and eventually to acquire full ownership. It was dissolved in 1938 and its functions carried on in a division of General Motors Corporation designated Motors Holding Division, referred thereafter in this petition as General Motors.

From 1935 through 1946, petitioner paid its managing officers pursuant to written contingent bonus agreements.

On April 30th, 1935, petitioner's directors (two of whom were General Motors nominees) approved a bonus agreement between petitioner and Abernethy. The pertinent paragraphs are

> "3. The Dealer Company agrees to pay the operator, as its President, in addition to his salary, a bonus equivalent to 50% of its net earnings commencing January 22, 1935, for the balance of the calendar year (and thereafter from calendar year to calendar year) in excess of 15% on its average month-end invested capital during said year or period.
>
> "4. Net earnings as used in the foregoing paragraph shall mean the net profits of the Dealer Company before deducting the bonus expense herein provided for. The accounting and reserve policies and procedures adopted from time to time by the Dealer Company shall be used as the base for determining said net earnings and profits." (Appendix A, infra, p. 6a)

The bonus was computed after the deduction of income taxes.

Needing help to run the company Abernethy in 1937 by agreement of a few months duration and then again in 1939 to induce E. R. McHenry to rejoin the company, agreed, in a personal contract between them, to pay a bonus to McHenry for his services amounting to one-half of the bonus to be received by Abernethy from the Company and for McHenry to own one-half of the stock purchased in the name of Abernethy from General Motors. (Appendix A, infra, p. 10a) Abernethy held this stock in trust for McHenry since it

was registered in his, Abernethy's name. The final transfer from General Motors to Abernethy was made on March 11th, 1941, and thereafter on March 19, 1941, Abernethy transferred 1/2 of his stockholding, 275 Class B shares, to McHenry and one share to his wife, Violet M. Abernethy. (Appendix A, infra, p. 7a)

In order to continue their bonus agreement entered into when General Motors controlled petitioner (the split of the 50 per cent of net profits etc.) Abernethy, McHenry and Mrs. Abernethy, the Directors, approved contracts between each, thus formalizing the arrangement with petitioner.[3] This contractual arrangement did not increase the potential bonus that could be paid each. It did not enlarge the burden nor immediately produce more compensation for them. It merely carried on the division of the 50 per cent bonus. In short their control of the company did not cause them to change their contingent compensation plan in order to procure more money for themselves.

The pertinent portions of the contracts are as follows:

> "3. The Dealer Company agrees to pay the Operator, as its President, in addition to his salary, a bonus equivalent to 25% of its net earnings commencing January 1st, 1941, for the balance of the calendar year (and thereafter from calendar year to calendar year) in excess of 15% on its average month-end invested capital during said year or period.
>
> "4. Net earnings as used in the foregoing paragraph shall mean the net profits of the Dealer

[3] It should be noted that the contracts are identical with the contracts between Abernethy and petitioner supra with only the date changed and the 50 per cent provision reduced to 25 per cent in each.

> Company before deducting the bonus expense herein provided for. The accounting and reserve policies and procedures adopted from time to time by the Dealer Company shall be used as the base for determining said net earnings and profits." (Appendix A, infra, p. 7a)

The bonus was also computed after deduction of income taxes.

Respondent arbitrarily disallowed the entire bonus of $4,527.67 paid to each officer, Abernethy and McHenry in 1945 and limited each of them to their $10,000.00 basic salary.

Respondent also arbitrarily disallowed the entire bonus of $30,881.69 paid to each in 1946 and limited each of them to their $12,000.00 basic salary.

Petitioner sought a redetermination by the Tax Court of the deficiencies assessed. The cause was heard before the Honorable C. Rogers Arundell on September 28, 1953, at Greensboro, North Carolina. Certain facts were stipulated. Other facts were developed through six witnesses called by petitioner. No witnesses were called by Respondent.

Obviously recognizing the bonus agreement results for the year 1945, the Tax Court allowed all of the bonuses computed and paid for that year. (Appendix A, infra, p. 19a)

Not so for the year 1946 however! Though high in its praise of both Abernethy and McHenry[4] the Court

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[4] "We think the record makes it clear that both Abernethy and McHenry were executives of superior ability and broad experience in the automobile business and that petitioner was fully justified in paying each of them in 1946 more than the $12,000 basic salary respondent determined as reasonable compensation

allowed a flat amount of $50,000.00 as total compensation for both, $25,000.00 for each officer, drawing no distinction between salary and bonus, with no regard for the contractual obligation of petitioner. (Petitioner had paid each man $42,881.69—salary of $12,000.00 and bonus of $30,881.69.)

The Tax Court in its opinion relied upon and cited only one case, and said as follows:

> "We had occasion to consider the effect of such a bonus plan in University Chevrolet Co., 16 T.C. 1452, affd. 199 F. 2d 629, and there decided that once the ownership of the corporation's stock has passed to the officers receiving the bonus, the fact that the compensation was paid in strict accordance with the agreement is in no sense determinative of the question of its reasonableness. The reasonableness of the compensation paid to Abernethy and McHenry must be determined on the basis of all of the facts." (Appendix A, infra, p. 17a)

Petitioner appealed to the Court below from that part of the decision involving 1946. The United States Court of Appeals for the Fourth Circuit in a per curiam decision, affirming the Tax Court's opinion, accepted the Tax Court's doctrine announced in *University Chevrolet Co., supra,* as follows:

> "A bonus contract which was reasonable as holding out an incentive to those managing the corpoation when its stock was owned by others could

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for each officer. The figure fixed by respondent was even less than the salary paid to Abernethy and McHenry in 1941 when each received approximately $18,000. The excellent and intelligent job done by these men in the period between 1941 and 1946 in promoting and expanding the business was quite outstanding." (Appendix A, infra, pp. 17a-18a)

well be held unreasonable when the managers themselves became owners of the stock and the question was not what incentive was needed to call forth their best efforts, but what part of the earnings of the corporation could fairly be paid to them for their services as officers. See University Chevrolet Co. v. Com'r, 16 T.C. 1452, aff. 199 F. 2d 627." (Appendix A, infra, p. 21a)[5]

REASONS FOR GRANTING THE WRIT

The decision under review urgently requires judicial correction.

The confusion which exists in the federal tax field of reasonable compensation is so great that no one can be reasonably certain that any contingent compensation contract will be recognized for tax purposes.

1. THE CONTINGENT COMPENSATION CONTRACTS. Although the respondent has established tests for these contracts in his regulations (Appendix B, infra), in this and many cases, these legal tests have become meaningless.

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[5] In the University Chevrolet case, the Tax Court's opinion states:

> "General Motors furnished the original capital, but under the plan, if successful, it would recoup that capital and meanwhile receive dividends. It could well afford to allow a large part of the earnings to go to the manager as a salary bonus in order to obtain a man who would build up a profitable business at the location and buy the stock of the corporation, all at no ultimate cost but with great benefit to General Motors. However, it does not follow that such a contract would be entered into at arm's length under different circumstances. The circumstances differed vitally once Davis became sole owner of the petitioner corporation.
>
> For a sole owner to pay himself a bonus as an incentive to do his best in managing his own business is nonsense".

So, today, the taxpayers find themselves in a situation (similar to that recently concerned with the family partnership confusion finally clarified by this Court in *Commissioner* v. *Culbertson*, 337 U.S. 722 (1949)). They are the victims of the application of incorrect legal tests to the facts and suffer since correct legal tests are disregarded by the respondent, the Tax Court and the Circuit Courts.

Petitioner in this case has been subject to such treatment. Respondent disallowed all compensation paid under contingent compensation arrangements negotiated at "arms length" years before the taxable year in question.

The Tax Court, relying on *University Chevrolet Co. Inc., supra,* having concluded that the bonus agreement "is in no sense determinative of the question of its (compensation) reasonableness" continued its opinion without further mention of the contractual bonus agreements and without giving any weight whatsoever to their existence.

The United States Court of Appeals for the Fourth Circuit, also relying on *University Chevrolet Co. Inc., supra,* affirmed the Tax Court and adopted the erroneous position that a contingent compensation contract can be reasonable at its inception and for years thereafter but becomes unreasonable by change in stock ownership. (Appendix A, infra, p. 21a)

The contingent compensation arrangement initiated with Abernethy in 1935 was unquestionably General Motors' agreed purchase price to obtain the services of Abernethy within the wording of the respondent's regulation

> ". . . if contingent compensation is paid pursuant to a free bargain between the employer and the individual made before the services are rendered, not influenced by any consideration on the part of the employer other than securing on fair and advantageous terms the services of the individual, it should be allowed as a deduction even though in the actual working out of the contract it may prove to be greater than the amount which would ordinarily be paid".
>
> (Reg. 111, Sec. 29.23(a)-6(2), Appendix B, infra)

Likewise, the contingent compensation arrangement commenced in 1937 between McHenry and Abernethy was, as testified to by both men, an absolute condition precedent to McHenry accepting employment (R. 20a, 27a) So on March 10, 1941 the situation was:

> (a) Strangers owned 100% of the voting stock;
>
> (b) Each of the operators, Abernethy and McHenry, were receiving, in addition to minimum salaries, contingent compensation in an amount equal to 25% of the profits after deductions previously mentioned.

As of March 10th, 1941, the Courts below would allow the entire compensation received by these men as reasonable (*University Chevrolet Co., infra;* T. C. Opinion, Appendix A, infra, p. 17a; CA-4 Decision, Appendix A, infra, p. 21a).

As of March 11th, when General Motors relinquished its control the respondent, the Tax Court and the Courts of the Fourth and Fifth Circuits hold that the contingent compensation contracts cease to be a factor in determining reasonableness.

The Sixth Circuit would not so hold. *Mayson Manufacturing Co.* v. *Commission,* 178 F. 2d 115.

The Tax Court in *University Chevrolet, supra,* even went to a further extreme in stating "For a sole owner to pay himself a bonus as an incentive to do his best in managing his own business is nonsense."

Petitioner, as a Corporation just as was University Chevrolet, is unable to comprehend that it lost its corporate entity for tax purposes when its voting stock changed ownership on March 11th, or that it was relieved of its contractual obligation to pay the bonuses.

Abernethy and McHenry continued to render the same valuable services to petitioner. Contingent compensation contracts do not depend upon stockholdings to produce revenue.

The doctrine of *University Chevrolet, supra,* is wrong—it is bad law—it discriminates against those employees who have free bargain employment contracts with corporation. When they subsequently obtain the controlling stock it destroys the contractual relationship.

According to the Court's reasoning in *University,* as applied in this case:

(a) A contingent compensation contract between a corporation and its President so that he can use the compensation to acquire ownership of the corporation, results in "reasonable compensation".

This erroneous test simply stated is "that how the employee spends his money rather than did

he earn it" determines whether the compensation is reasonable.

(b) That same contingent compensation arrangement becomes "nonsense" after the officer obtains control of the corporation even though he continues to furnish the same or more valuable services to the corporation.

This conclusion is indirectly based on the false premise that the corporate entity is to be disregarded as to existing compensation plans as of the date the stock control changes hands.

If Abernethy and McHenry had in each year in question used their authority as controlling stockholders and directors to vote themselves the bonuses paid, the Commissioner would have a point. But no such procedure was followed. The contracts which produced the bonuses were continued in 1941. They were not altered or amended but faithfully carried out without change. If in the years in question, Abernethy had owned all of the stock, McHenry's bonus would have been as great as it was, and the same as Abernethy's, and vice versa.

The compensation paid under the contingent contract between petitioner and Abernethy and McHenry was not, by any stretch of the imagination determined by their stockholdings.

If General Motors had retained its interest, they would have received the same amount. If either Abernethy or McHenry had remained alone, he would have received double the amount. The stock ownership did not bring on the increased earnings. Their ability to take as much as they pleased did not enlarge their

earnings. The stock control they had over the corporation did not increase their bonus compensation. Admittedly, each could have received 50 per cent of the profits from General Motors. Both had worked under such contracts previously and both testified that they would not have remained in the company's employ if they had not received this bonus agreement.

In fact in their dealings with each other, all the aspects of arms-length transactions are evident, McHenry came and went several times and each time exacted a bonus as payment for his services in developing the company. And Abernethy on his part, used the bonus to bring him back and secure his valuable services for petitioner.

Certainly one can hardly claim that either took advantage of petitioner by forcing a bonus agreement under the then prevailing conditions and circumstances of world, national and local unrest and uncertainty, at a rate well below that which other companies would have paid them. *Cp. Austin et al.* v. *U. S.*, 28 F. 2d 677 (CA5-1928). They are at least entitled to payment at a rate they would have paid others or others would have worked for, or others would have paid each of them.

One's stockholdings should not bar equal treatment for oneself with strangers, when such a plan is reasonable and has been so stated to be by uncontroverted testimony.

The very contingent nature of the bonus provides for liberal compensation in good years and less compensation in the less profitable years. It was held in *Austin* v. *U. S., supra,* that the fact that "in the actual working out of the contract contingent compensation

may prove to be greater than the amount which ordinarily would be paid" was no ground for the denial of part of the deduction. See *Thomas N. Perkins et al.* v. *Commissioner,* 33 BTA 606, 623—(1935); *Howard Sole, Inc.,* para. 53,076 P-H Memo. T.C., Docket No. 34082 (1953); *Robert Rogers, Inc.* v. *United States,* 93 F. Supp. 1014 (Ct. Cls. 1950).

This Court in *Lucas* v. *Ox Fibre Brush Co.,* 281 U.S. 115 (1930) has held that compensation paid in a current year for services performed in earlier years is deductible in the current year providing the amount currently paid when added to what has already been paid for the earlier years is not unreasonable.

That case did not involve contingent compensation but it is of import here since by their very nature, contingent compensation contracts provide no compensation in years of no profits when, nevertheless, efforts and services might be maximum.

University Chevrolet Co. Inc., supra, while apparently approving an incentive bonus for buy-out purposes denies such approval when control of the company passes to the employee. This decision and what is more alarming, its application, is definitely in conflict with the Court of Appeals for the Sixth Circuit. In *Mayson Manufacturing Co.* v. *Commissioner,* 178 Fed. 2nd 115 (CA6-1949), the Court considered the Tax Court's failure to give due weight to the bonus contract substantial error. The compensation plan disregarded by the Tax Court was established in July 31, 1929 at a time when the beneficiaries of the plan were not controlling stockholders. Subsequently, the controlling stockholder died (April 6, 1939) and his stock was redistributed among the surviving stock-

holders, who continued as employees and paid themselves out of the bonus fund established.

The Commissioner challenged the payments to the then controlling stockholders in 1943, a war economy year. The Court reversed the Tax Court, holding that the arm's length contract of long standing should have been considered.

We commend this decision to this Court for its analysis and application to the facts in the case at bar. The Fourth Circuit apparently did not appreciate the similarity and seems to have been misled by the buy-out provisions of Abernethy's and McHenry's contracts with petitioner. Petitioner maintains that cannot govern.

2. THE COMMISSIONER OFFERS NO EVIDENCE. Another important principle is involved in this case concerning which there exists a definite conflict between several United States Courts of Appeal.

The Sixth Circuit holds that the taxpayer's claimed amount of reasonable compensation cannot be reduced by the Courts if qualified witnesses testify to the reasonableness of the salary, and the Commissioner does not supply evidence to the contrary. *Roth Office Equipment Co.* v. *Gallagher,* 172 F. 2d 452 (CA-6, 1949); *Wright-Bernet, Inc.* v. *Commissioner,* 172 F. 2d 343 (CA-6, 1949); *Mayson Mfg. Co.* v. *Commissioner,* 178 F.2d 115 (CA-6, 1949); *The Loesch & Green Construction Co.* v. *Commissioner* (C.A. 6, No. 11932, March 2, 1954), citing prior cases par. 72,411 P-H Fed. 1954.

The Fifth Circuit, in a 1950 case, applied the above principle in *J. H. Robinson Truck Lines, Inc.* v. *Commissioner,* 183 F. 2d 7 (CA-5, 1950). Then after tem-

porarily changing this position in a 1951 case, the Court in 1953 said:

> "Since the Commissioner offered no evidence, the petitioner was denied the opportunity of examining the correctness of his computations and was left to stand upon its own proof, none of which was refuted. Therefore, we think the burden of presenting evidence to rebut any presumption in favor of the Commissioner's findings was fully met, and the Tax Court clearly erred in finding that the salaries were unreasonable." *R. P. Farnsworth & Co. Inc.* v. *Commissioner,* 203 F.2d 490 (CA-5, 1953)

This pronouncement of the law by the Fifth Circuit is likewise the law established by other Federal Courts of Appeal:

See:

> *A & A Tool & Supply Co.* v. *Commissioner,* 182 F. 2d 300, 39 A.F.T.R. 517 (C.A. 10, 1950)
> *Heywood Boot & Shoe Company* v. *Commissioner,* 76 F. 2d 586. (C.A. 1, 1935)

Other Circuit Courts have taken a contrary view. *R. H. Oswald Co., Inc.* v. *Commissioner,* 185 F.2d 6 (C.A. 7th); *Anchor Co.* v. *Commissioner,* 42 F. 2d 99 (C.A. 4th); *Builders Steel Co.* v. *Commissioner,* 197 F.2d 263 (C.A. 8th).

Petitioner does not question the right of the Courts below to draw inferences and to weigh the evidence.

However, when the respondent can arbitrarily disallow a deduction and then not be required to defend his position in Court, an unfair burden is placed upon the taxpayer. As stated in *Mayson Mfg. Co., supra,* "No opportunity was afforded petitioner to

cross examine any witness who might have testified for the respondent to the contrary or to test the correctness or fairness of the figures selected by the respondent and the Tax Court."

As a result the judges of the Courts below do not receive all necessary evidence in the cases to reach a logical conclusion.

MERTENS LAW OF FEDERAL TAXATION, Sec. 50.71 in discussing questions of evidence states, in effect that the presumption that respondent's assessment of the tax is prima facie correct merely means that, in the absence of evidence to the contrary, respondent's assessment will be sustained, but when there is contrary evidence, this presumption vanishes. The presumption is not evidence itself—it only shifts the burden of going forward with the proof.

In this case respondent produced no witnesses, offered no testimony and introduced no evidence to contradict the unimpeached and uncontradicted testimony of the qualified, impartial witnesses who testified that in their opinion the compensation paid to Abernethy and to McHenry for the year 1946 was reasonable.

Likewise, respondent offered no evidence or testimony that the compensation paid was unreasonable for any reason.

Neither the Tax Court nor the Fourth Circuit required the respondent to justify his determination. Thus this case unhappily follows the pattern of compensation cases with an arbitrary disallowance by respondent, followed by a Tax Court or District Court hearing in which the respondent offers no evidence and a decision establishing an allowable amount greater

than the Commissioner's but less than the taxpayer had claimed. RESEARCH INSTITUTE OF AMERICA, FEDERAL TAX COORDINATOR, Sec. H-2104, pp. 26,111, 26,351-26,368.

CONCLUSION

We have presented to this Court for its consideration, serious conflicts that exist in the Courts below—conflicts that can be reconciled by this Court only. No other court has the authority or ability to do so.

Unless the law is clarified the tax burden will continue to fall unfairly upon taxpayers who must present their cases before unsympathetic tribunals. Accident of residence will govern.

Wherefore, this petitioner prays this Court that a writ of certiorari be granted.

Respectfully submitted,

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April 1956